

DOW THEORY LETTERS INC.

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Letter 551

Dec. 22, Dow 1004.21, PTI 1017, A-D ratio -2.52

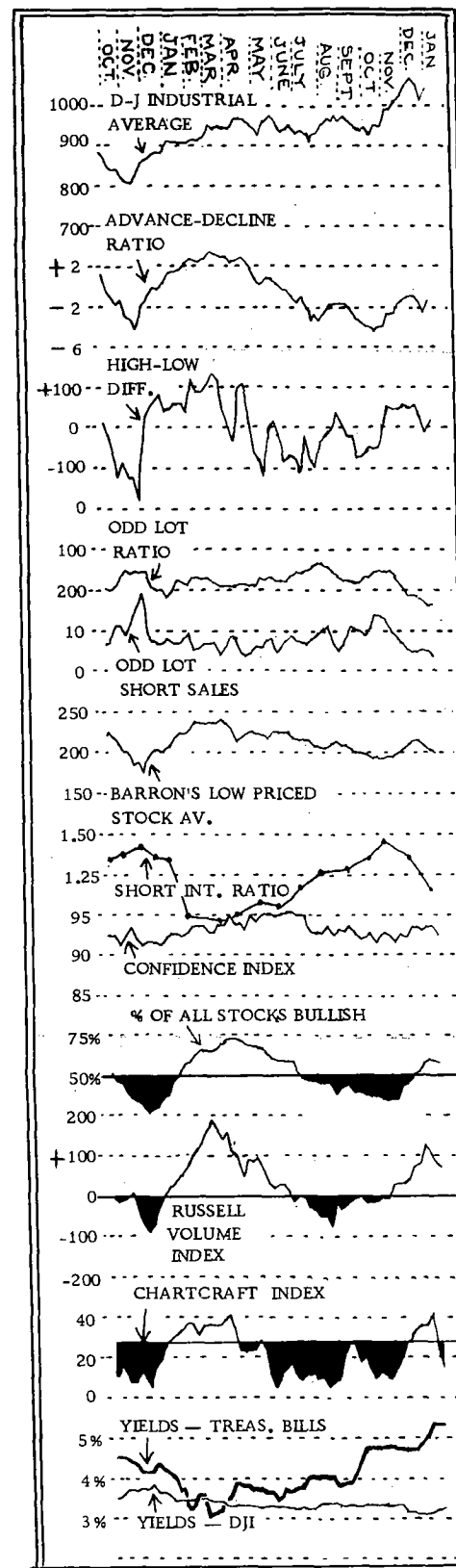
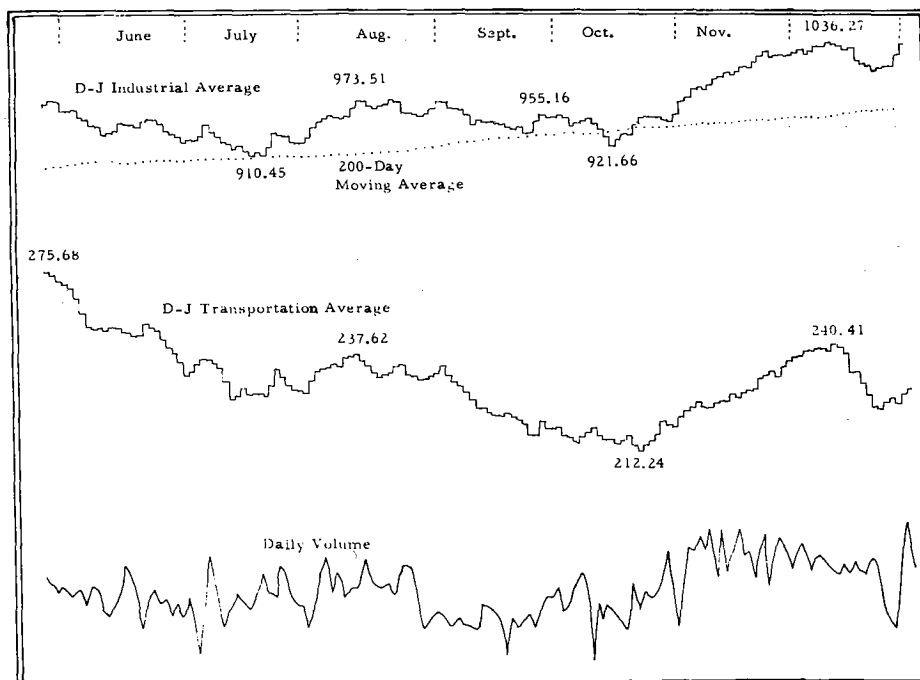
Dec. 29, Dow 1020.02, PTI 1028, A-D ratio -2.18

1973: This is the time when the soothsayers like to present their "forecasts" for the coming year. I am going to avoid this exercise in arrogance. Medicine, which is certainly nearer a science than market analysis, would hesitate to "forecast" a patient's health for the year ahead, but most market "doctors" are not so modest. Their motto is "give the patient what he wants," and if the customer wants an annual forecast, well, why not work something up? After all, by February or March the forecasts are forgotten anyway.

But what we can examine is the current technical condition of the market. A glance at the chart of the Averages (see below) shows that the latest decline from the December highs has created a few technical problems. The chart is drawn to ratio (percentage) scale, and it can immediately be seen that the most recent decline in Transports was more acute than that of Industrials. Thus, the Transports have preserved their status (which they have held all year) of being the weaker of the two Averages.

On the October-December advance, Industrials established an all-time high of 1036.27. Transports, however, failed to get within 35 points of their 1972 high of 275.68. This sets up an important non-confirmation and a potentially dangerous situation. The picture is aggravated by the further December weakness in Transports, since this action suggests that on the latest rally, it will be all the Transports can do to better their 240.41 peak of December, much less advance above their 1972 high of 275.68.

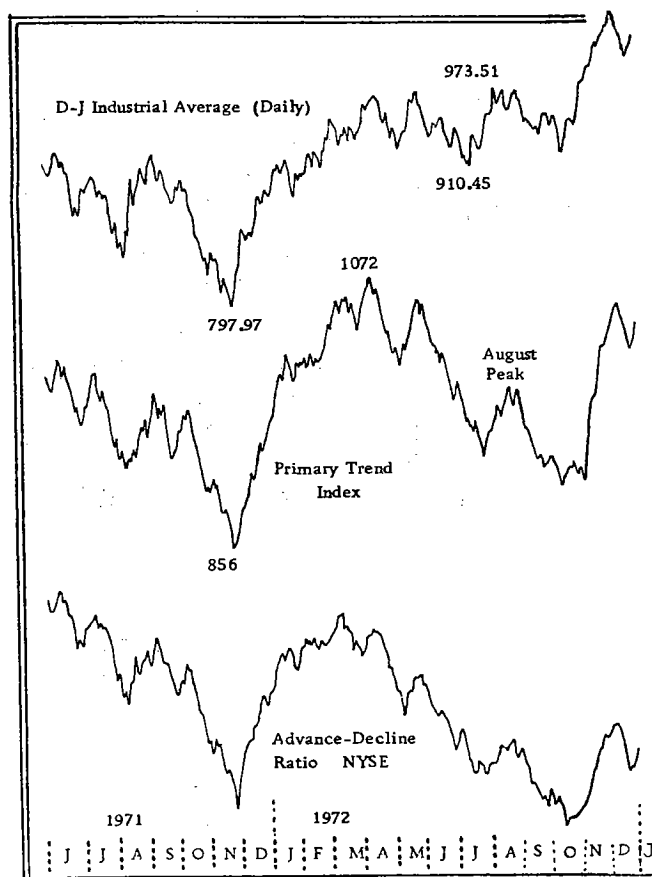
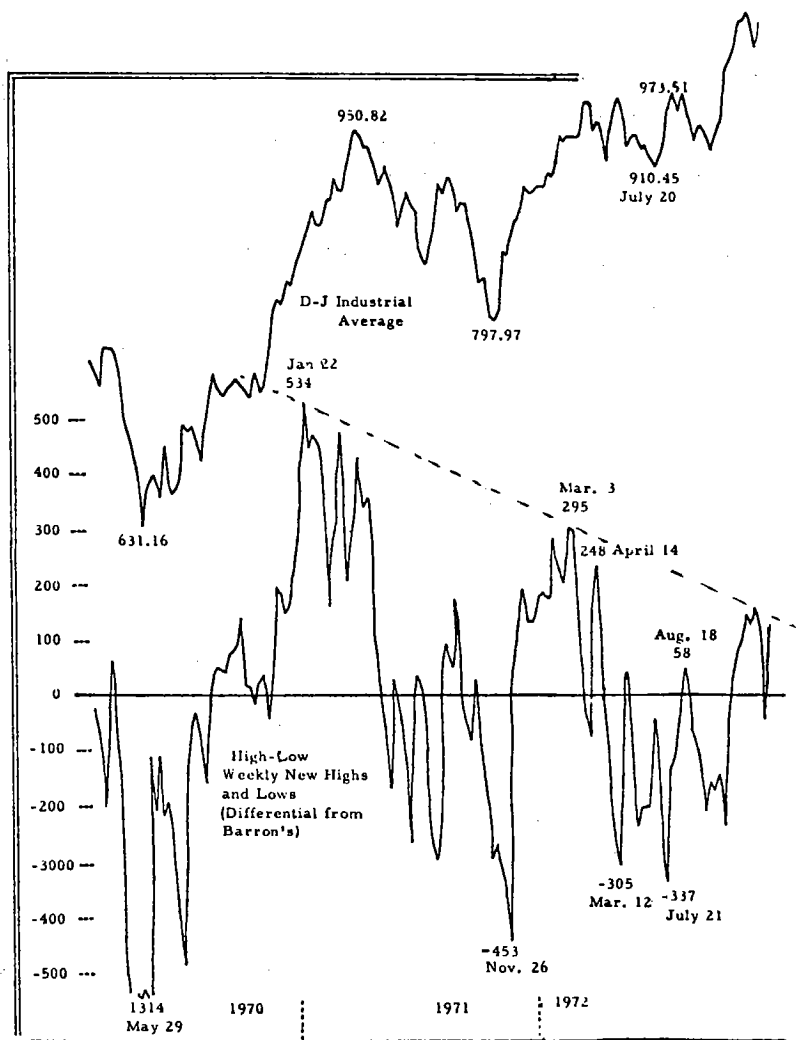
The last trading day of 1972 was ushered out (amid new peace rumors and reinvestment demands) by a 12 point jump in the Dow. The New Year saw an 11 point rise as the cessation of the bombing of Hanoi brought in more enthusiastic buying. By mid-week the Dow was bouncing to all-time highs — but Transports, the sluggish



Page 2 non-confirming Transports, there is the catch! Actually, I am usually quite suspicious of explosive market action (either up or down) during the first few days of a new year (remember 1960 and the termination of the Great Steel Strike?), but the trading during the second week is usually more meaningful for trend indications.

The difficulty and selectivity of this market is providing more frustrations for traders and investors than any market seen in years. On this page I show a chart of the weekly high-low differential on the NYSE, and this chart is more revealing. It is immediately apparent that the path of the D-J Industrials has been up since 1970. On the other hand, the high-low differential peaked in January, 1971, at 534, this with the Dow Industrials at 861. The next high-low peak came in March, 1972, at 295 on the high-low (Dow at 942). The most recent high-low peak was established a few weeks ago on December 8 at 158, this with the Dow at 1033. To emphasize the collapsing high-low picture, I have drawn a descending trendline through the three tops.

Turning to the next gauge of Wall Street, study the chart of the Dow, the Primary Trend Index and the A-D ratio. Here again we see why this market has been so difficult (dare I say discouraging) to the public and the professional alike. At the bottom of the chart we see the most recent (October to December) rise in the A-D ratio. This rise was the best in eight months but nevertheless



was far weaker than the early 1972 advance. Furthermore, the December decline wiped out almost half of the A-D ratio gains. Thus, since the A-D ratio tends to measure the performance of the average portfolio, we can say that the entire year 1972 (despite record highs in the Dow) was a "bust" as far as the typical investor was concerned.

The Primary Trend Index (PTI) did fare considerably better than the A-D ratio on the October-December rally, and actually this indicator of the market's technical position got within shooting distance of the May, 1972, peak. But here it stopped, and there is no point trying to outguess this crucial indicator over the coming months. Suffice it to say that it has not (so far) confirmed the Dow in that the PTI has failed to better its own 1972 high. I consider the path of the PTI over coming months to be critically important in providing indications as to the market's next real direction.

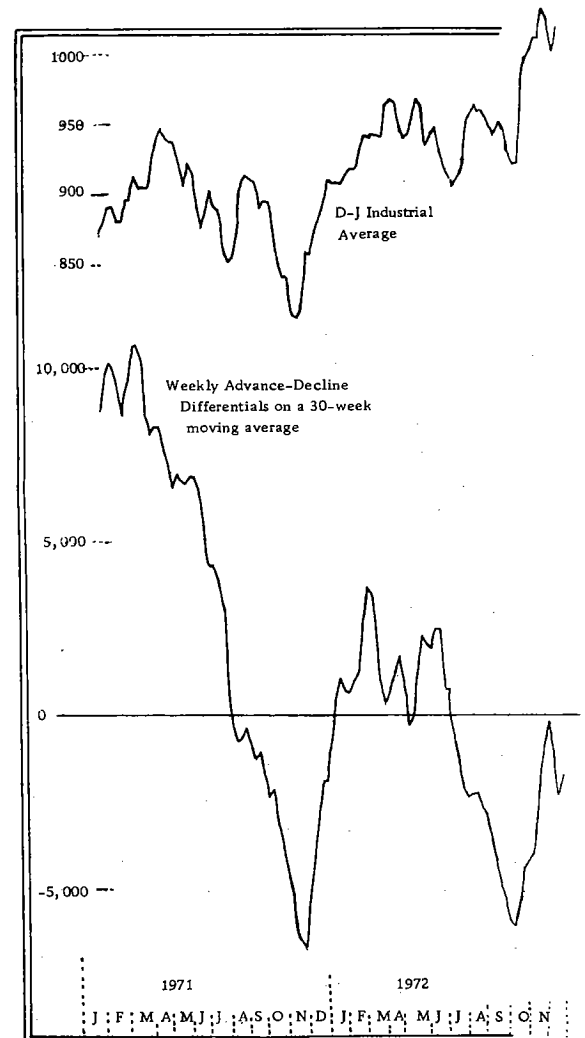
Note that the PTI did not break to a new 1972 low last October as did the A-D ratio. Thus the PTI was saying that the technical situation was not as bad as we might have thought if we were watching the A-D ratio alone. Note also that the PTI acted better than the A-D ratio on the advance since October. Thus it was again saying that the market picture was not as hopeless as the A-D ratio was indicating. Therefore, I feel that the PTI will provide the really valuable hints as to the market's true technical condition during 1973. PTI action will be covered thoroughly in coming reports, and subscribers may wish to chart the Dow and the PTI weekly figures as provided at the top of page 1 in each of these mailings.

LONG-TERM BREADTH INDEX: This is a most important indicator for identifying the long-term direction of "the market" (a review of this index appeared last in Letter 547). What we are seeing on the accompanying chart is the weekly pluralities of advances or declines, arranged in the form of a 30-week moving average. For instance, if on a given week 800 issues advanced and 1000 declined, we have a plurality of minus 200. The figure 200 is then subtracted from the 30-week total and the 31st figure is dropped. We then have the new 30-week total.

The 30-week index can provide us with three different pieces of information: (1) Whether the index is moving in the same direction as the Dow Industrials, (2) whether the index is building a series of higher peaks or whether it is failing and therefore moving sideways or down, (3) whether the 30-week total is above or below the zero level.

As seen on the chart, the 30-week index is now looking bearish. On the major 1972 decline, despite heroic resistance by the Dow, the Index plunged to minus 6000, almost as low as the 1971 low of minus 6500. The index bottomed out in early October, and actually turned up before the Dow did.

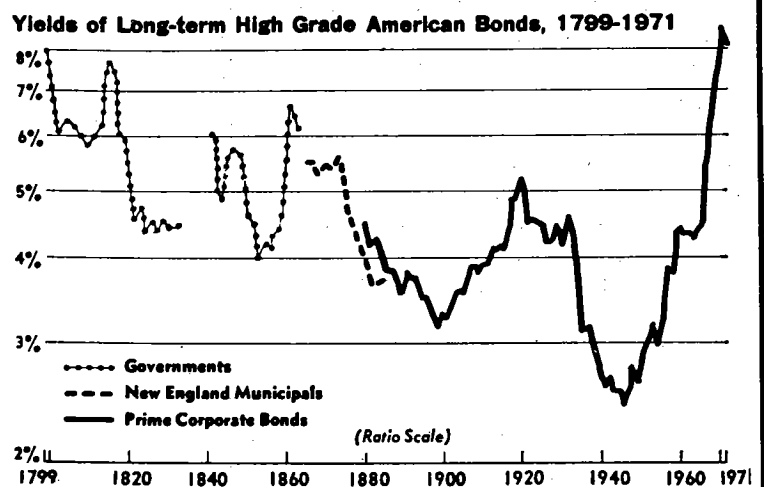
On the week ending December 8, 1972, the Index had risen to minus 200, its best level since July, 1971. Then it turned down, having failed to climb above zero. I feel that this performance is very significant, and it shows why the public is still so discouraged about Wall Street, why they continue to sell their odd-lots and why they are still redeeming their mutual funds. The fact is that market breadth has been abysmal ever since March, 1971. I view the "above zero" level of the index as the "above water" mark, the point at which on a 30-week basis stockholders tend to break even on their investments! And here we see that just as the latest rally approached the zero level, it died and turned down. This kind of action on the 30-week breadth index has never been associated with profits on Wall Street!



KONTRATIEFF: Speaking of generations, I have had many inquiries about the recent book by Roseanau and Shuman entitled, "The Konratieff Wave." This book explores a wave theory put forth by a Russian (Nikolai D. Konratieff) in the 1920's. Mr. K. found that since the 1800's, giant cyclical fluctuations in the US take place in the form of approximately 52-year cycles. These cycles can be seen in charts of both long-term bond interest rates and in wholesale prices.

To illustrate, I include this chart of bond rates from 1799 to the present (courtesy of The Money Manager, formerly the Bond Buyer, 77 Water St., NYC 10005). Note that the preceding peaks occurred during the War of 1812, the Civil War (1865), World War I, and now (or during the Vietnamese War).

As a rule in past history, periods of high bond yields (such as those illustrated) end amid massive liquidation of debt usually accompanied by financial panic and/or depression. Such periods are represented by the valleys in the bond yield curves. So obviously, the question is — have we reached another peak in the Konratieff cycle? We are now roughly 50 years beyond the yield peak which occurred just after World War I. Interest rates are approximately in their highest area since the Civil War. Many of the elements which go to make up



Source: Sidney Homer, Salomon Bros.

a period of liquidation are now present — speculative excesses built into the economy, huge debt, inflation, great faith in the power of government to prevent disaster, an expensive war in progress, and a period of great social liberty and political and social change.

When a great Chinese philosopher was asked for an epithet which would fit any and all occasions, he thought and said, "This too shall pass away." And that is all I will say of the Russian cycle theorist and the Chinese philosopher.

INFLATION, MONEY RATES AND THE MARKET: As the New Year is ushered in, inflation is becoming literally the "fifth horseman" of the Apocalypse. It is spreading like a plague across the face of the Free World. In Europe money is going into paintings, silver, coins, artifacts, antique guns, jewels and gold. In the US money seems to be going into (1) Vietnam, and (2) into overseas central banks, due to the continuing disastrous balance-of-payments deficits.

Interest rates in Europe are rocketing, with central banks in Europe having raised their bank rates a dozen times in the past three months. In the US the Fed dreamily sticks to its 4.5% discount rate, a rate which has held for more than a year.

With the double incentive of trade surpluses and higher interest rates, dollars continue to pile up in Europe and Japan. The widening spread between short-term interest rates of the US and Europe are shown rather dramatically on the accompanying chart. This should add to the current pressure to move US interest rates higher.

In Letter 549 (and I hope subscribers are filing back-letters for reference) I included a chart of money-oriented market indicators. That chart is up-dated here. Note that the Utility Average has turned down and that the D-J 40-Bond Average has leveled off. When both of these indices turn decisively down the market climate is considered negative, and I would say that any persistent decline in the Bond Average would now rate this dual indicator negative.

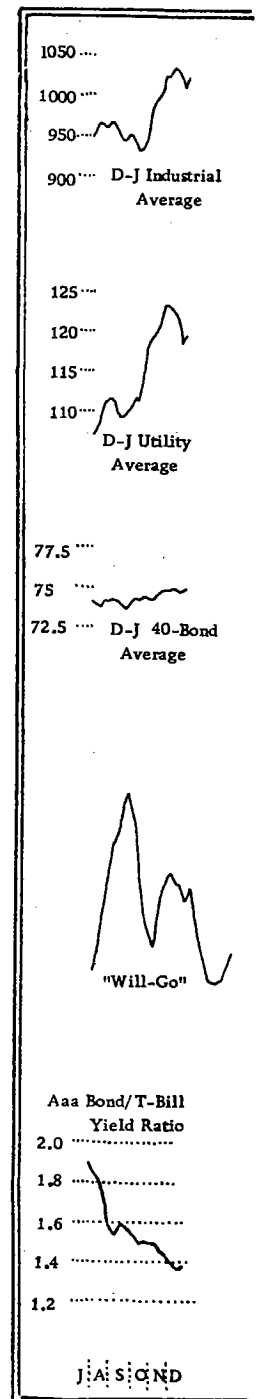
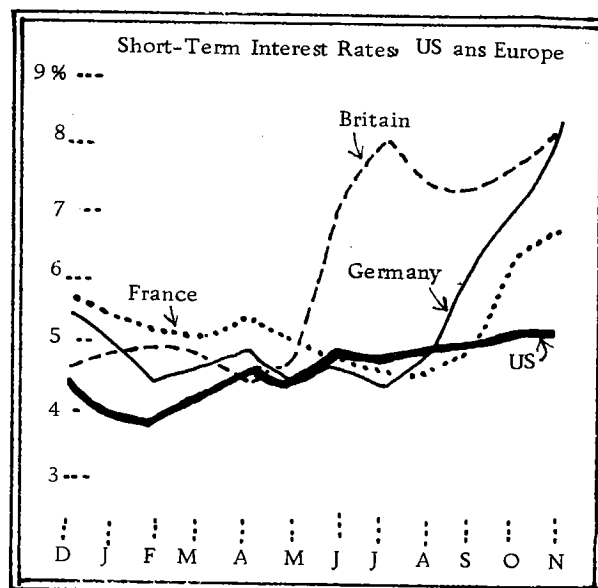
"Will-Go" which is based on the spread between bond and stock yields hit its most recent peak on October 25. Allowing for the usual 10-week lead time, Will-Go is saying that the market would turn down around the first week in December. The most recent low on Will-Go was struck December 4. Allowing 10-weeks lead time, Will-Go is saying that the market should continue down until around mid-February. Remember, Will-Go does not forecast extent, only direction.

Finally, the Aaa Bond/T-Bill yield ratio index has now broken decisively below 1.40, and it has thus given a first "sell signal." When this ratio drops below 1.40 (as explained in Letter 549) this is the signal for a general tightening up in the monetary picture. Already we have had a boost in stock margins, a raise in the bank prime rate and a general sagging across the board in the various sectors of the bond market. A drop below 1.20 in the Aaa/T-Bill yield ratio index constitutes a "strong sell signal." In order to receive such a signal, Treasury bill yields will have to climb, Aaa bond yields will have to decline, or both movements would have to occur.

The chart of US and foreign short-term interest rates suggests that US rates are out of whack on the downside, far too low compared with Europe. Therefore, it would not surprise me to see Treasury bill yields climb to and above 6%. If that occurs, we will almost certainly receive a strong sell signal on the Aaa/T-Bill yield index.

Conclusion: The entire interest rate-monetary picture suggests trouble ahead for the stock market. Remember, the indices shown on this monetary chart work best in money-sensitive stock markets. This stock market is most definitely money-sensitive.

THOUGHTS: I attended prep school in NYC, graduating in 1942 (Horace Mann). Jack Karouac was there at the same time (a class or two ahead of me). Karouac



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was the "father" of the "beat generation," author of the book, "On the Road," and numerous other novels. I knew Jack fairly well. In those days he went to school on a football scholarship, and aside from being a rebel, there was little hint that he would reach fame before he died.

I have, for some strange reason, never read any of Jack's books. My daughter has been raving about his writing, and recently I showed her Jack's picture in our high school year book, then decided myself to read "On the Road." It has been quite an experience. Some of the faintly disguised characters in the book I knew well. But I must say that I felt much as Jack did as he took his first outlandish, mad, irrepressible ride across the country to arrive at his beloved "West." Thus he writes, "I suddenly realized that I was in California. Warm, palmy air — air you can kiss — and palms." Jack loved life; he literally ate it up, and it ate him up. He died an untimely death in his 40's, burnt out, exhausted, a rocket coming back to earth.

"Life is holy," he writes, "and every moment is precious." He catches the fantastic, dreamy, wild, soothing, never-never land atmosphere of the Coast. The land of the future, the land of the past, the land where everything is accepted and where everything is tried. Personally, I really can't explain why I love the West so much, but I guess Jack Kerouac comes nearest to explaining it for me. Yet Jack was totally honest, open, and he spares no one and no place. For instance, here's what he writes about Los Angeles, "...I never felt sadder in my life. LA is the loneliest and most brutal of American cities; New York gets God-awful cold in the winter but there's a feeling of wacky comradeship somewhere in some streets. LA is a jungle."

I've often felt as if I'm living midway between three generations, my generation of World War II and the 1940's (hideous times but with a purpose), the generation of the 1950's (which I found depressing and boring), then the late-1960's and early 1970's, in which the seeds of hope and sanity (I feel) are emerging. This is the generation which has finally begun to produce real personal freedom, it is questioning everything, how we live, how we spend our time, our money, our lives, how we spill our blood.

So when people tell me about the "good old days" I am not even polite. They were the days of pre-inflation (or at least inflation wasn't so obvious) and an honest day's work, but they were also the days of repression, deadness, boredom, non-think, and the days which I found basically "heartless." James T. Farrell summed it up in the preamble to one of his early books: "Alone and afraid, in a world I never made." I don't feel the world is like that anymore.

Yesterday, I sat on the sea-wall here in La Jolla in 80 degree weather looking at huge breakers smashing against the rocks. I was watching the lovely water spouts from four gray whales as they headed south down the Coast to Baja for the winter. And I was thinking, what would Jack Kerouac have said if he could have been sitting on this same cement wall, here as 1972 turns into 1973? I'll bet he could have really put it down for posterity. But I guess God decided that Jack had written enough. And as for me, I feel as if somehow the work is just beginning...

FACTS MR. NIXON WILL OMIT FROM THE INAUGURAL ADDRESS: In 1971, for each \$100 in a savings account (actually in a savings & loan account, which pays higher than a bank savings account) you received \$5.33 in interest. But inflation wiped out \$3.36 of this. You also lost \$1.33 of this to Federal taxes. This left you with a return of 64¢. If you paid state taxes too, you must about have broken even. The situation remains unchanged to worse during 1972.

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The US is the principle benefactor of Cambodia. It is now admitted that as much as one-third of the pay marked for the Cambodian Army has been given to "fighting men" who do not exist!

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The US now pays the full salaries of over one million soldiers in the S. Vietnamese Army. This, to support an army in an undeclared war. The reason for the war is the same as the one that put us in Korea — to provide the Asian people with the right to self-determination in government.

Results after the Korean War and the Vietnamese War which is still going on: South Korea under martial law (ruled by General Hee), South Vietnam under martial law (under General Thieu), Cambodia under martial law (Gen. Nol), Thailand under military dictatorship (Field Marshal Kittikachorn).

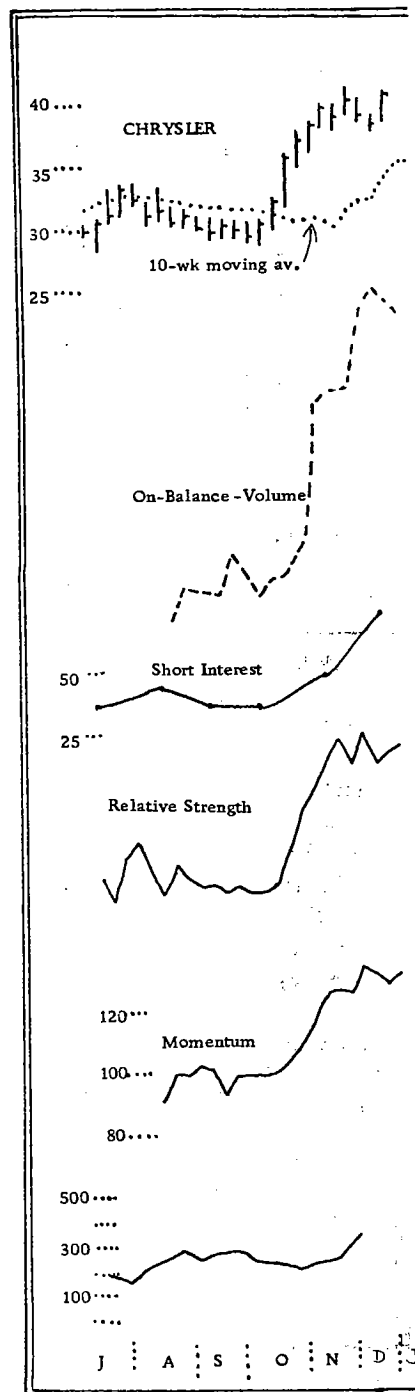
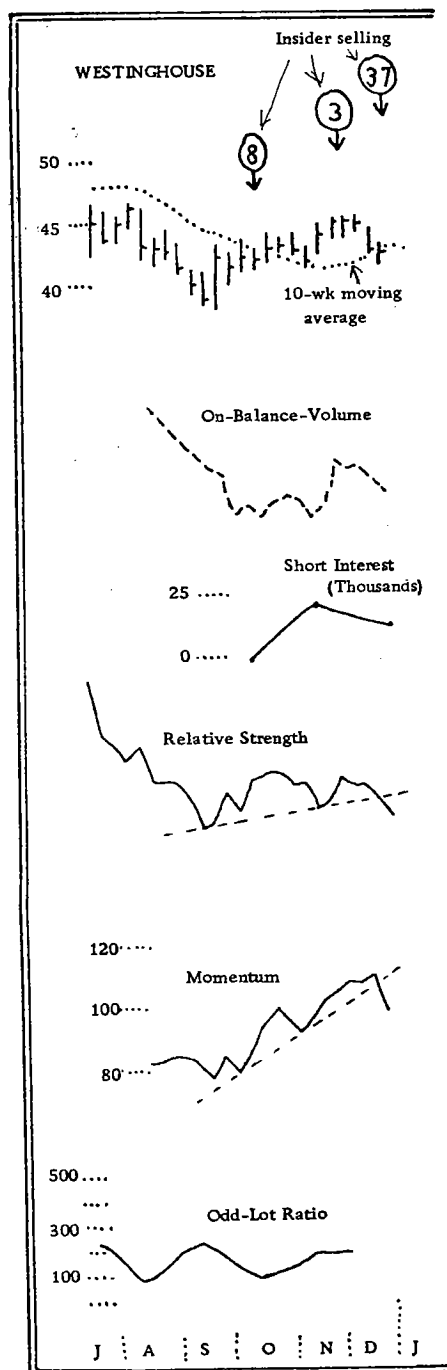
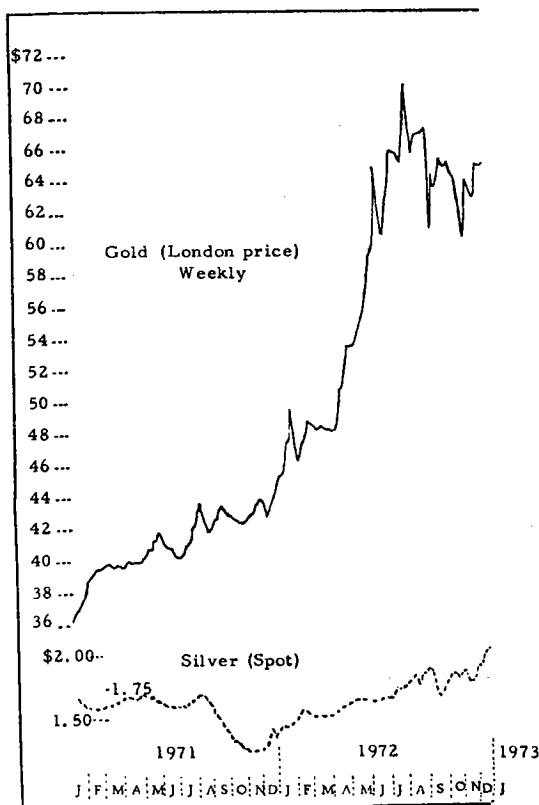
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For 80 years the US has run positive trade balances with the rest of the world. In 1971, even though the overall trade surplus disappeared, we still ran a \$1.3 billion trade surplus with the six nations of the European Economic Community. At present the US is running a trade deficit with every major industrialized area of the world, including the Common Market. The worldwide US trade deficit for 1972 is expected to be about \$6 to \$7 billion.

Page 6 **STOCKS:** Each week I add up all the ratings in the 30 Dow Industrials. The peak of 96 was hit in mid-December, that figure dropped to 68 last week. Strongest stock is Chrysler with a 6 rating (Telephone next with 5), weakest are Int. Nickel, Westinghouse and Woolworth all with zero ratings.

I include the chart of Chrysler (C), and here we see the broad technical strength in this issue. Note that relative strength and momentum are both rising, meaning that C is not only trending above its price of 13 weeks ago but also acting better than the market. Odd-lots are picking up their selling in C as the rise continues, a bullish indication.

Westinghouse (WX) is at the other end of the spectrum. Note the reversals to the downside in relative strength and momentum. I show three areas of insider selling, and the figures in the circles represent thousands of shares sold by insiders. Although not always correct, the insiders tend to be correct, and at least with WX they are right on the technical picture, which suggests weakness on all fronts. I have noticed that relative strength and momentum often provide the first indications of a change in trend. Along these lines, the rel.



strength and momentum lines in the three Dow oils (Texaco, St. of Calif. and Exxon) are now weakening, suggesting to me that the move in the oils is approaching an end.

GOLD & SILVER: Although not clear on the accompanying weekly chart, the gold bullion price is in a large "head-and-shoulder" bottom pattern, with a rise above \$66 being an upside "breakout." I suspect gold could be at a new all-time high during the first quarter. This would constitute a strong stimulus for the still bargain-priced S. African gold shares. Silver is now above \$2 per ounce, and seems to be locked into a strong rising trend. It would not surprise me to see silver at \$2.50 to \$3.00 during 1973.